(26)

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1944

No. 1024

In the Matter of

WAERN BUILDING CORPORATION,
Debtor.

ERNEST MORRILL,
Petitioner,
vs.

WAERN BUILDING CORPORATION,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

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OPINION BELOW.

The District Court did not render a written opinion but merely entered an order confirming the plan of reorganization as amended (R. 210-212). The Referee filed reports on the petitioner's objections to the plan (R. 93-109, 157-174).

The opinion of the Circuit Court of Appeals (R. 232-239) has been officially reported at 145 Fed. (2) 584.

STATEMENT OF THE CASE.

A statement of the matter involved has been fully presented in our petition and the Court is respectfully referred to pages 2 to 6 therein. In the interest of brevity, the statement is not repeated here.

SPECIFICATION OF ERRORS.

The Circuit Court of Appeals erred:

1. In holding as fair and equitable a plan of reorganization which reduces the interest rate to bondholders and at the same time allows stockholders participation.

2. In holding that a *specific* objection to a plan of reorganization that it violates "priority rule" must be raised by a creditor in the District Court before it can be urged on appeal.

3. In holding the plan of reorganization feasible which further extends a bond issue where, from the past earnings record of the real estate involved, the net income will be insufficient not only to meet the current requirements of the plan but to retire or refund the debt at the end of the extension period.

4. In failing to distinguish between a *hearing on a plan for submission to the interested parties*, pursuant to Sec. 174 of Chapter X of the Bankruptcy Act and a *hearing on confirmation* of the plan under Sec. 221.

5. In holding the evidence did not warant investigation and removal of the indenture trustee.

6. In holding that it was not error for the District Court to refuse to authorize a plan for the sale of the debtor's property *because that would be tantamount to liquidation.*

SUMMARY OF ARGUMENT.

1. A plan of reorganization which permits stockholders to participate and at the same time reduces the contract rate of interest to bondholders violates the "absolute priority rule" as announced by this Court in the *Boyd Case* and *Los Angeles Lumber Case* and is not fair and equitable as a matter of law.

2. The opinion of the Court of Appeals holds that since petitioner, an objecting bondholder, never specifically objected in the District Court to the violation of the absolute priority rights of bondholders he is precluded from raising the question on appeal. The record shows that petitioner objected to the submission of the plan and to its confirmation on the ground that it was *not fair and equitable, or feasible.* Under Chapter X of the Bankruptcy Act and the applicable decisions of this Court, it is the affirmative duty of the District Court, even though no objections are filed, to reject a plan which from the face of the record violates the priority rights of bondholders.

3. The court below disregarded the test of feasibility laid down by this Court to the effect that the debtor's normal earning capacity is the most important criterion in determining the feasibility of a plan of reorganization. In the case at bar, the Debtor's sole asset consists of a furnished apartment building, some fourteen years old. The plan under consideration provides for a second extension of the bonded debt for six years, with periodic payments of interest, taxes and deposits in a sinking fund for retiring the bonds, totaling an amount which the Debtor, even when the building and furnishings were newer, has never been able to earn. Temporary present earnings due to the current housing shortage caused by

the war, constitute no criterion for determining whether or not the plan is feasible.

4. At a hearing on the question of whether or not a plan should be approved for submission to creditors and stockholders pursuant to Section 174 of Chapter X of the Bankruptcy Act, there should be available to the Court and interested parties competent valuation data from disinterested sources relating to the Debtor's property and earning capacity to the end that the Court may exercise its own "informed, independent judgment" concerning the fairness and feasibility of the plan and the interested parties may intelligently vote on the plan. The submission of such data *after consents have been procured* does not satisfy the statute.

5. The Court of Appeals and the District Court failed to follow the holding of this Court in *American United Mutual Life Insurance Company* v. *City of Avon Park*, 311 U. S. 138, in requiring the indenture trustee, the underwriter of the bond issue, to make a complete disclosure of its activities.

6. Chapter X, Section 216 (10) of the Bankruptcy Act authorizes the approval of a plan providing for a sale of the Debtor's property at an upset price. *Fidelity Assurance Association* v. *Sims*, 318 U. S. 608, does not prohibit the approval or confirmation of such a plan.

ARGUMENT.

I.

A plan of reorganization which permits stockholders to participate and at the same time reduces the contract rate of interest to bondholders violates the "absolute priority rule" as announced by this Court in the Boyd Case and Los Angeles Lumber Case and is not fair and equitable as a matter of law.

It is now a firmly established principle in federal reorganization law that "any arrangement of the parties by which subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of * * * creditors comes within judicial denunciation." *Louisville Trust Company* v. *Louisville, New Albany & Chicago Railway*, 174 U. S. 674; *Northern Pacific Railway Co.* v. *Boyd*, 228 U. S. 482; *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106. It is equally settled that any plan of reorganization which violates the full priority rights of creditors is not fair and equitable as a matter of law and may not be approved by the Court. *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106; *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510.

Applying these rules here, we submit the plan is not fair and equitable. Under the bonds and the trust indenture (R. 56) bondholders were entitled to receive interest at the rate of *5% per annum from May 10, 1939, to May 10, 1942, and interest at the rate of 7% per annum after May 10, 1942,* the maturity date of the bonds. Under

the plan the interest rate to bondholders is reduced from 7% to 4½% from May 10, 1942, to May 10, 1948, and at the same time stockholders are permitted to participate.

It is significant that two of the three judges of the Court of Appeals who heard this case apparently did not concur with Judge Kerner, who wrote the opinion, in his holding that the priority rule was not violated. Judge Kerner said (R. 234):

> "My colleagues concur in the conclusion that appellant is precluded from raising this question for the first time on review. The author of this opinion, however, feels impelled to add this paragraph *which represents his own personal opinion.*" (Italics ours.)

Judge Kerner then proceeds to state that the priority rule is not violated because any stockholder participation is more nominal than real, being restricted, so far as any beneficial enjoyment goes, to the distant future; that stockholders do not receive any dividends; that although the corporation has legal title to the property, all the earnings must be used for the benefit of the bondholders, and that *Group of Industrial Investors* v. *Chicago, Milwaukee, St. Paul & Pacific Railroad Co.,* 318 U. S. 523, 546, does not hold "that a provision in the original bonds as to an accelerated rate of interest after maturity must be the interest rate which is to be included in the plan if stockholders participate." (R. 234-235)

It is true, as Judge Kerner says, that bondholders receive the entire net earnings of the building until their bonds are fully paid, and the shareholders' right to receive any part of the earnings is correspondingly postponed. However, the interest rate is cut down and to the extent it is reduced the interest of the equity owner increased. What is taken from the bondholders is given to preferred stockholders. Stockholders benefit in direct proportion to the extent the interest rate to bondholders

is cut down. If there is, in fact, an equity for the stockholders then there is no basis for depriving the bondholders of their full contract right, viz., 7% on their bonds for the full period of extension. If there is none, then, of course, they should not participate at all either presently or because of any optimistic belief in the future. Since any curtailment in the contract rate of interest to creditors increases correspondingly the equity of the stockholders, in this sense stockholders definitely participate in the plan and benefit, though their enjoyment of financial benefit is postponed. If bondholders here receive only 4½% interest instead of 7%, as provided in the contract, stockholders get the benefit of interest at the rate of 2½% per annum, about $3500.00 a year, or about $20,000.00 over a period of six years.

On the subject of interest, this Court said in *Group of Investors, et al. v. Chicago, Milwaukee, St. Paul & Pacific Railroad Co.*, 318 U. S. 523, 546:

> "Finally, it is argued on behalf of some of the stockholders that the effective date of the plan under Section 77B must be the date of the filing of the petition, the theory being that Section 77B does not permit the accrual of interest after that date. In *Consolidated Rock Products Co.* v. *DuBois, supra*, we held, under Section 77B that *interest on secured claims accrued to the effective date of the plan was entitled to the same priority as principal.* The definition of the terms 'creditors' and 'claims' was substantially the same under Section 77B, Sub. (b) as it is under Section 77 * * * We see no reason why the same result should not obtain here." (Italics ours.)

Commenting on the question of interest, the court said in *Consolidated Rock Products* v. *Du Bois*, 312 U. S. 510, 527:

> "In the first place, no provision is made for the accrued interest on the bonds. This interest is entitled to the same priority as the principal."

We do not understand the holding of this Court to mean (as the Court of Appeals ruled) that the Court distinguishes between interest which accrues *before maturity* and interest which accrues *after* the *maturity* date of the debt. We understand the *priority rule* to mean that creditors are entitled to full compensatory treatment in accordance with their contract before stockholders may participate.

The instant plan was not approved and confirmed until November 8, 1943 (R. 210). By that time about seventeen months' interest at 7% had accrued (from May 10, 1942), which, under the holding in the *Milwaukee* case (318 U. S. 523, 546), was entitled to the same priority as the principal. Even this was eliminated by the plan (R. 13). In its treatment of the interest upon the principal indebtedness the Court of Appeals, therefore, went directly contrary to the decision of this court as to interest on secured claims.

Escape is sought, in the opinion below, from the full effect of the priority rule by resort to the theory that the provision for interest at 7% applies to the period after maturity and that "the very soul and purpose of the present plan is to extend the maturity date" (R. 234). This, it is respectfully urged, is both unrealistic and unsound. There is no magic in the word "maturity." The contract, including the obligation to pay interest, is as much alive after final payment is due, as it was before. Extensions of maturity provided by plans of reorganization under Chapter X must contemplate extension of the then existing obligation which includes principal and interest at the contract rate when default occurs. The default occurring, the agreed condition to the increased interest rate came into being. The debt under the first extension already had matured when the debtor came to court with its voluntary petition. That maturity was an accomplished fact and that same

maturity was not extended under the present, second reorganization. Rather, a *new* maturity date for the payment of the obligation of a *new* corporate entity was created under the plan.

Rights of first mortgage creditors must be considered as they are when listed as debts in the proceeding. The proof of their claims contemplates proof of the existing indebtedness. After that demonstration the court considers what may fairly and equitably and feasibly be done with the existing situation of the debtor, which must include the total of its contract obligations as to both principal and interest. The first mortgage bondholders here possessed the right by contract to receive 7% interest after May 10, 1942. The plan destroys that right, and, furthermore, permits stockholders to participate in the new corporation.

The 7% interest rate payable after maturity, as provided by the 77B plan of 1936, is authorized by the Statute of the State of Illinois. Chapter 7, Sec. 4 (Interest) Illinois Revised Statutes (1943) State Bar Association Edition. Virtually all mortgages or trust indentures in the State of Illinois provide for interest at the rate of 7% after maturity. Courts of Illinois have uniformly upheld the provision of interest at 7% after maturity in suits on notes and foreclosures on mortgages. *Schmisseur* v. *Rebhan*, 13 N. E. (2d) 627, 294 Ill. App. 172, 179 (1938); *Arneson* v. *Haldane*, 105 Ill. App. 589; *Carson* v. *Rebhan*, 13 N. E. (2d) 630, 294 Ill. App. 180, 183 (1938); Reeve, Illinois Law of Mortgages (1932), Vol. 1, p. 185; also Vol. 2, p. 740. Federal District Judge Campbell of this district has approved several plans allowing 7% after maturity as fixed by bonds and mortgages. (Windsor Wilson Liquidation Trust, Jeffery Terrace Building Corporation, Karcher Hotel Co.)

In *Coder* v. *Arts*, 152 Fed. 943, 950 (C.C.A. 8th) the Court said:

> "... the mortgagee is entitled to payment of the interest upon his mortgage debt as well as the principal, out of the proceeds *in accordance with the terms of the note and mortgage.*" (Italics ours.)

Assuming instead of an extension of the bonded indebtedness the property had been sold and the sale had produced a sum sufficient to pay bondholders the full principal of their bonds plus accrued interest, would bondholders have been entitled to 7% interest after May 10, 1942, the maturity date, or an "average" fixed by the debtor? It would seem that they would be entitled to 7% after maturing before any distribution of the funds could be made to stockholders. Are the rights of bondholders any less because their bonds are extended in a reorganization proceeding? If the indenture trustee had proceeded with its foreclosure, there can be no question but that bondholders would be entitled, as a matter of right, to a decree of 7% after May 10, 1942, in accordance with their notes and with the trust indenture.

The 4½% rate provided in the plan is the average rate which the bondholders received from 1936 to 1942. If the debtor is permitted to pay an "average" rate of interest it has paid over a past period, it would appear to be legally permissible for the debtor to pay less than an average. What, then, becomes of the "priority rule"? If an average for the past six years may be taken, why not an average from the time the bond issue was created in 1928 when the interest rate was 6%? A reasonable rate of interest does not satisfy the contract rights of bondholders. A rate of interest in accordance with the temporary, current money market is not the test of fairness. (The Referee found that the interest rate was a "favorable" one in these times (R. 105).) It cannot even be said that bondholders who have been receiving 5% interest from 1939 to 1942 are in as good a position by a plan which now offers them 4½%. The opinion of the Court

of Appeals holds that stockholders have no real participation because they get no income until the bonds are paid. This is no answer to a reduction or confiscation of their contract right to receive full compensatory treatment. What is taken from bondholders goes to stockholders.

The Court of Appeals completely neglected to observe the important and immediate, though non-financial, participation accorded to shareholders under the plan. As far as the property is concerned, stockholders control it; they control the legal title; they control the management of the building during the extension period. Only in case of default will control pass to bondholders.

The effect of the plan compels the conclusion that bondholders are not accorded their full priority rights which the decisions of this Court require be given them before stockholders are allowed participation. Hence, the plan is not fair and equitable as a matter of law.

II.

The opinion of the Court of Appeals holds that since petitioner, an objecting bondholder, never specifically objected in the District Court to the violation of the absolute priority rights of bondholders, he is precluded from raising the question on appeal. The record shows that petitioner objected to the submission of the plan and to its confirmation on the ground that it was not fair and equitable, or feasible. Under Chapter X of the Bankruptcy Act and the applicable decisions of this Court, it is the affirmative duty of the District Court, even though no objections are filed, to reject a plan which from the face of the record violates the priority rights of bondholders.

It is, of course, settled that an objection may not ordinarily be raised for the first time in a reviewing court.

However, a federal reorganization proceeding is not like ordinary litigation which is determined on the basis of evidence which the parties choose to submit. In this case the debtor sought relief, modification and extension of its obligations to creditors and the Congress has provided certain statutory admonitions to prevent the technically captious treatment of creditors' rights. Even if no objections have been raised to a plan of reorganization, it is the duty of the District Court to examine the record and determine if a plan is fair and equitable as a matter of law. The court is the guardian of those creditors who have not assented to the plan—in this case, about 18% of the bond issue or about $25,000.00 in bonds (R. 141-144).

Sec. 174 of the Bankruptcy Act (11 U.S.C.A. 47) specifically provides:

> "* * * The judge shall enter an order approving the plan or plans * * * which are fair and equitable, and feasible * * *"

Sec. 212 of Chapter X of the Bankruptcy Act provides:

> "The judge shall confirm a plan if satisfied that the plan is fair and equitable, and feasible * * *"

The Bankruptcy Act thus places on the Court, irrespective of objections filed, the positive duty to examine into the fairness and feasibility of a plan. As this Court said in *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, 114:

> "A contrary conclusion in such case would make the judicial determination on the issue of fairness a mere formality and would effectively destroy *the function and duty imposed by Congress on District Courts under Section* 77B." (Italics ours.)

This Court said in *First National Bank* v. *Flershem*, 290 U. S. 504, 525:

> "In justifying the action taken, *the Court of Appeals called attention to the fact that the non-assent-*

ing creditors had not introduced any evidence to prove their contentions that the sale should not be confirmed. * * * The failure to secure an adequate price seems to have been due, not to lack of opposing evidence, but to the mistaken belief that it was the duty of the court to aid in effectuating the Plan of Reorganization since a large majority of the debenture holders had assented to it. *Moreover, the Court stood in a position different from that which it occupies in ordinary litigation where issues are determined solely upon such evidence as the contending parties choose to introduce.* In receivership proceedings, as was held in *National Surety Co.* v. *Coriell*, 289 U. S. 426, 436, every important determination by the court calls for an 'informed, independent judgment'." (Italics ours.)

Finletter, The Law of Bankruptcy Reorganization (1939), says at page 474:

> "The Act places on the Court the positive duty of examining the proof as to fairness and feasibility. The minority is not to be put to the expense of assembling the evidence to the contrary. Any such burden would be too severe. The Court in effect is the guardian of those who do not assent to the proposal * * *"

Here, the trust indenture was in evidence as part of the record (R. 59-82). A mere reading of it discloses that bondholders are entitled to 7% interest after maturity or May 10, 1942. It was patent from an examination of this document that the rights of bondholders were violated by the plan. It is settled that one is not required to specifically object to what is apparent from an inspection of the record. We objected to the submission of the plan and its confirmation on the ground that it was not fair and equitable, and feasible (R. 104, 153). While the Court of Appeals deemed this general objection insufficient, it is submitted that the District Court is not thereby relieved of its duty to examine the trust inden-

ture and to determine if the priority rights of creditors have been violated. An entire class of creditors may not be penalized merely because the Court's attention was not directed to a violation of the contract rights of creditors. Chapter X of the Bankruptcy Act furnishes the District Court ample facilities—by the appointment of a Special Master or (as in this case) a Referee, or an examiner, or a trustee—to determine and advise the Court if the superior rights of creditors are preserved.

The opinion of the Court of Appeals fails to recognize this established rule in federal reorganization law—the function and duty imposed on District Courts to examine the plan and the proof to determine if the plan is fair and equitable as a matter of law. The opinion views reorganization proceedings as ordinary litigation compelling creditors to exercise vigilance and diligence in asserting their rights lest they lose or waive those rights. Petitioner, the opinion holds, should have specifically objected in the court below. Failing to do so, he (and it follows all the bondholders) have lost their rights. This is not the intent or the spirit of the Act or the decisions of this Court.

III.

The court below disregarded the test of feasibility laid down by this Court to the effect that the debtor's normal earning capacity is the most important criterion in determining the feasibility of a plan of reorganization.

In the case at bar, the Debtor's sole asset consists of a furnished apartment building, some fourteen years old. The plan under consideration provides for a second extension of the bonded debt for six years, with periodic payments of interest, taxes and deposits in a sinking fund for

retiring the bonds, totaling an amount which the Debtor, even when the building and furnishings were newer, has never been able to earn. Temporary present earnings due to the current housing shortage caused by the war, constitute no criterion for determining whether or not the plan is feasible.

The feasibility of a plan of reorganization is fundamentally essential to its confirmation. While courts are not required to possess infallible prescience, they must, in estimating the future, take heed of past earning experience. There should be some reasonable assurance from the history of the enterprise and from rationally anticipatable earnings that the plan will be carried out so that further resort to judicial aid will be unnecessary.

On this subject, this court said in *Consolidated Rock Products* v. *DuBois*, 312 U. S. 510, 525:

> "Whether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities is a *sine quo non* to the determination of the integrity and practicability of the new capital structure."

The court said further, at page 526:

> "The necessity for such an inquiry is emphasized by *the poor earnings record of this enterprise in the past.* Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization. * * * it is also essential for satisfaction of the absolute priority rule of *Case* v. *Los Angeles Lumber Products Co., supra.* Unless meticulous regard for earning capacity be had, indefensible participation of junior securities in plans of reorganization may result." (Italics ours.)

That the income resulting from operations augmented by war conditions is no test for the appraisal of the future,

was held by this court in the *Milwaukee Railroad* case, 318 U. S. 523, where the court said at page 543:

> "We cannot assume that the figures of war earnings could serve as a reliable criterion for that 'indefinite future.' "

Quoting from a statement of the Interstate Commerce Commission, the court said, at page 543:

> " 'We know from past experience that the upswing in business which war brings is temporary and likely to be followed by an aftermath in which conditions may be worse than before.' "

Then, using language certainly applicable to the plan under consideration, the court said (page 543):

> "As some of the bondholders point out, the bulge of war earnings *per se* is unreliable for use as a norm unless history is to be ignored; and numerous other considerations, present here as in former periods, make them suspect as a standard for any reasonably likely future normal year."

The limited economic life of real estate enterprises requires even more scrupulous compliance with standards of sound finance than ordinary industries. Corporate reorganization of real estate enterprises has constituted a vast bulk of reorganization proceedings in the courts of this country. The failure to restrict debt to proper limits with respect to earning power has been the chief cause of widespread defaults on real estate mortgages. It has been estimated that over 60% of the outstanding real estate bond issues in this country defaulted. The limited economic life of a piece of real estate is a factor which serves to emphasize the necessity of retiring debt even more than in the case of industrial enterprise. Usually an industrial company makes provision by way of depreciation reserves for replacing capital assets which have

become worn out or obsolete. Earnings set aside annually can be used to buy plant and equipment, enabling the enterprise to keep abreast of developments and to meet competition, thus living and growing with the times and prolonging its life indefinitely. These opportunities are not available to owners of real estate. Equipment can, of course, be replaced, but there is little that can be done to overcome the obsolescence of a building. If a building no longer attracts tenants because it is old or because of a shift of tenants to other and better neighborhoods, purchase of new equipment and major alterations are of only limited assistance in staving off eventual loss of income. The tempo of obsolescence increases with age. It is vital, therefore, that retirement of debt of a real estate company should be regular and sufficiently substantial to offset depreciation so that at the maturity date the debt may be retired or readily refunded and any plan of reorganization for such enterprises must be reasonably calculated to accomplish this objective.

The Securities and Exchange Commission on January 31, 1944, released an opinion in the matter of *In Re Senwest Corporation,* (Commerce Clearing House Bankruptcy Report No. 155) (February 11, 1944), containing the following significant language concerning feasibility of a plan of reorganization involving real estate:

> "In approving a plan of reorganization the Court is required by the provisions of Chapter X of the Bankruptcy Act to find that it is feasible. A definition of feasibility is the soundness of the proposed capital structure. If bonds are to be issued, there should be reasonable assurance that earnings will be sufficient in amount and stability to provide regular payments of interest. *In addition, particularly in the case of of a real estate company such as the debtor, where the chief asset has a limited economic life and funds are not set aside for its replacement, the soundness of the proposed capital structure also depends, in a*

> *large degree, on the bond issue being regularly reduced so that at maturity any remaining principal can be readily paid or refunded."* (Italics ours.)

In Re Philadelphia & Western Railway Co., the Securities and Exchange Commission released an opinion on May 18, 1943, (Commerce Clearing House Bankruptcy Report No. 136) saying:

> *"If bonds are to be issued they should not exceed an amount on which interest can be paid regularly out of reasonably assured earnings, together with sufficient payment on principal so that at maturity the remaining bonds can be paid or readily refunded."* (Italics ours.)

In the light of these tests, the plan here involved is, plainly, not feasible. If the past is any criterion, the debtor will not be able to meet its current obligations of interest, taxes, insurance, sinking fund deposits, trustee's fees, renewal and replacement of furniture and furnishings. No figures were presented to show the earnings of the building from 1928 to 1937, but it is apparent from the record of payment to bondholders and the necessity for reorganization in 1936, that the income was grossly insufficient to service the debt. From 1938 to 1940 (R. 235) the average gross income was slightly over $28,000.00 per annum. Average annual operating expenses for the period were about $15,000.00, leaving about $13,000.00 for the payment of taxes, which were about $3300.00 per year; interest of $6400.00 per year; insurance (not shown in the record but which runs about $1000.00 per year) and trustee's fees ($300.00 to $500.00 per year), making total estimated charges exceeding $11,000.00, and leaving a balance of $2000.00 for the sinking fund ($3500.00 required annually). There was an average annual deficit of at least $1500.00 per annum for the sinking fund and this without pro-

vision for replacement or renewals of furniture, fixtures and equipment.

McKey, an appraiser, testified the building has been literally "starved" so far as upkeep was concerned. He said the greater part of the furniture was installed when the building was built; that the carpeting needs renewal and replacement; that because of war conditions the building is now fully occupied, but in the post-war period this building will not attract unless it is modernized (R. 29). Depreciation of the personal property—a vital factor in a furnished apartment building—was ignored in valuation.

This building has never in any normal period been able to earn sufficient to meet the current commitments undertaken by this plan, a factor completely disregarded by the courts below. Until the war came and the housing shortage developed, this building was in constant difficulty.

Fourteen years of unsuccessful past performance constitutes a fairly definite indication that the debtor will not be able to meet its current obligations under the plan.

Periodic retirement of debt should exceed depreciation by a reasonable margin. The Referee found that the present market value of the property was $150,000.00 and its economic value $160,000.00 (R. 163), although there is no evidence to warrant this economic valuation. He found the building had an economic life of sixty years. If this finding be accepted (although there is no basis for it) then this building has a remaining economic life of forty-five years. Considering an economic valuation of $160,000.00 and a remaining life of forty-five years, and depreciating the property at 2¼% annually, it is apparent that depreciation would amount to about $3700.00 per annum as against debt retirement of $3500.00 per annum. On a market valuation of $150,000.00 depreciation would just about equal debt retirement.

A building of this character, however, has, at most, an economic life of fifty years. With a remaining life of thirty-five years its normal depreciation is about 3% annually. On an economic valuation of $160,000.00 the property will depreciate $4800.00 annually and debt retirement, if the plan succeeds, would be $3500.00 per annum. If the market value of $150,000.00 be accepted, then annual depreciation would be $4500.00 against debt retirement of $3500.00 a year. Physical depreciation is an absolute certainty. Retirement of debt under this plan is an uncertainty. The fact that during the past fourteen years the average retirement of debt has been approximately $1500.00 per annum compels the conclusion that future retirement will be substantially less than depreciation.

Will the Debtor be able to retire or refund the debt at the end of this second extension period? Here, again, the past earnings record of the building condemns the plan. The Court of Appeals concedes that, "*the ratio of debt to the value of property will be high,*" but declares that "it will not necessarily be so high as to make some new financial arrangement impossible or improbable that we may say as a matter of law that the plan is not feasible" (R. 236). The Court of Appeals states the test in the negative—"we cannot say the plan is not feasible." We submit that feasibility requires an affirmative test—reasonable probability that the plan will succeed. Under the opinions of this Court, the law does not contemplate a succession of experiments with investors' funds.

The original amount of the bond issue in 1928 was $165,000.00. From 1928 to 1936, $8000.00 in bonds were retired or an average of $1000.00 per year. In 1936, the debt was $157,000.00 and the Debtor could not pay it. It asked for and obtained a six year extension under 77B. Under the 77B plan it agreed to retire $3500.00 in bonds annually or $21,000.00 over the six year period. From 1936 to 1942 (operating under the 77B plan) $15,800.00 in bonds were

retired or an average of \$2500.00 per year. The record does not show whether these bonds were retired at par or whether the Debtor or indenture trustee was able to purchase the bonds at less than par. The 77B plan authorized the acquisition of bonds at the lowest tendered price. We venture the speculation that many of these bonds were retired at less than par and the Debtor had considerably less than \$15,800.00 available for bond reirement. The 77B plan failed by over \$5000.00 in debt retirement. How does the Debtor propose to achieve in the future what it has failed to accomplish over the past 14 years?

In our argument on whether the plan was "fair and equitable", we stated there was no legal warrant for reducing the interest rate from 7% to 4½% and at the same time permitting stockholder participation. If we are right and the interest rate of 7% must be paid, then this plan is rendered still further unfeasible because the Debtor will be required to pay bondholders, not 4½% per annum, but 7%, and with this additional annual obligation of about \$3500.00 or \$21,000.00 over 6 years the plan cannot possibly succeed even if extraordinary war conditions continued for another six years.

The confirmation of the plan by the courts below resulted from a hopeful optimism wholly unjustified by any realistic appreciation of the history of the Debtor. Current war earnings alone persuaded the lower courts to approve this plan as feasible. The past earnings, under the same management, spread over the record of many years' operations, were ignored. If any normal period be considered, it is not reasonable to expect that, under the plan, the Debtor will meet its current obligations and it is beyond the range of probability that the debt will be retired or refunded at the end of the second extension period. If, at each approach to the maturity of its funded obligations, a debtor gets ready to expire and the pulmotor of reorganization is summoned, then there will be little hope for investors

for the ultimate payment of obligations held by them within any reasonably expectable period. On the face of it, a first mortgage debt of $141,800.00 does not seem soundly secured by property, the market value of which, appraised during a period of high prices, is only $150,000.00.

The plan fails to meet the legal and practical tests of feasibility. The prospect of a third reorganization may be clearly envisioned. Of the debtor enterprise, it may be truly said that the "past is prologue."

IV.

At a hearing on the question of whether or not a plan should be approved for submission to creditors and stockholders pursuant to Section 174 of Chapter X of the Bankruptcy Act, there should be available to the Court and interested parties competent valuation data from disinterested sources relating to the debtor's property and earning capacity to the end that the Court may exercise its own "informed, independent judgment" concerning the fairness and feasibility of the plan and the interested parties may intelligently vote on the plan.

At a hearing before the Referee to determine whether or not the plan should be approved for submission to creditors and stockholders, we asked the Court to appoint a competent and disinterested appraiser to evaluate the property of the Debtor (R. 26) to assist the court and the interested parties in determining the value of the property, and at the same time we informed the court that no bondholders could afford the expense of an appraisal and unless the expense was defrayed by the estate, bondholders were at a disadvantage. Our petition was denied (R. 84).

In his report recommending the approval of the plan for submission the Referee made no finding of the value of the property (R. 107). His report asserts that Haynie, an employee of the indenture trustee and a member of the bondholders committee (formed by the indenture trustee), testified that in his opinion the property had a fair cash value of approximately $155,000.00. Haynie did not qualify as an expert and it did not appear that he made a study of the earning power of the building. He testified that he merely looked at the building in the morning in anticipation of coming to court in the afternoon and testifying as to its value (R. 21). His testimony was tantamount to a guess. The banks as indenture trustee has a personal stake in the plan. It receives fees and deposits. The Referee concluded that because the property was, in his opinion, worth more than $141,800.00 stockholder interests could not be disturbed, and that no showing was made by the objector that the plan was not fair and equitable, and feasible. The report recommending the approval of the plan makes no analysis of past or prospective earnings (R. 107). After the requisite consents had been obtained and at a hearing on confirmation the Referee heard evidence for the first time from three interested appraisers (R. 236).

Secs. 174 and 175 of Chapter X of the Bankruptcy Act provides for a hearing on a plan to determine whether it shall be submitted to creditors and stockholders. It is submitted that this hearing contemplates the presentation of full valuation data concerning the assets of the Debtor. A mere statement by an interested witness that the property is worth $155,000.00 without any analysis of earnings, operating expenses, depreciation data, taxes, condition of furniture and finishings, etc., is not the kind of evidence which should constitute the basis of a plan of reorganization. Full and disinterested information should be required by the Court before a plan is approved for

submission. The defect is not cured by hearings on confirmation. Not having the necessary information before confirmation, creditors could not intelligently vote on or determine whether the plan was fair and equitable, or feasible, and the Court could not exercise its independent judgment. The defect is vital. *Even the appraisals at the hearing on confirmation,* all produced by interested parties, were insufficient. Following were the opinions of the various appraisers:

Name of Appraiser	*Opinion of Valuation*	*Basis for Valuation*
Frank Mc McKey, appraiser for appellant	$139,550.00	Earning capacity
Ivar W. Turnquist, appraiser for debtor	150,000.00	Original cost less depreciation
Wilbur C. Haynie, appraiser for indenture trustee	155,000.00	Cash market value

Turnquist, the debtor's appraiser, testified that the building was worth $150,000.00 and *he reached that amount by figuring the original cost at $225,000.00 and allowing a depreciation of $75,000.00* (R. 43). Haynie, appraiser for the bank as indenture trustee, merely said the property was worth about $155,000.00. McKey, petitioner's appraiser, testified that the property was worth $139,550.00 (R. 33). McKey examined the building in detail, analyzed its past earnings record, taxes, insurance, operating expenses, necessity for renewals of furniture, furnishings and equipment, and said that a prudent investor would be justified in demanding a return of 8% to 9% on his investment in this property. McKey thus capitalized the building at $139,550.00. McKey's analysis is, we submit, the approach required by the *Consolidated Rock Products* case, 312 U. S. 510, where this Court said, p. 525:

"Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization. Unless meticulous regard for earning capacity be had, indefensible participation of junior securities in plans of reorganization may result."

Other valuations were not and are not predicated on the earning capacity of the building. Nor was an attempt made by them to capitalize the property on a fair return on investment. The Referee found the economic value of the property to be $160,000.00. How he reached that figure is not shown by the record (R. 163). The principle for which we are contending is that in these circumstances the District Court should have appointed an independent appraiser with directions to examine meticulously into the earning capacity of the building and to present his (the appraiser's) findings at a hearing on the question whether the pending plan should be approved for submission to the interested parties. Until such data is available, neither the Court nor interested parties can properly pass on the merits of this or any other plan of reorganization.

V.

The Court of Appeals and the District Court failed to follow the holding of this Court in American United Mutual Life Insurance Company v. City of Avon Park, 311 U. S. 138, in requiring the indenture trustee, the underwriter of the bond issue, to make a complete disclosure of its activities.

The record here discloses that the Chicago City Bank and Trust Company, indenture trustee, has acquired bonds totalling $11,100.00 (R. 85), and owns in other capacities over $6000.00 in bonds (R. 85-86). This is over 10% of

the bond issue. It was not disclosed to the Court or to bondholders how and when these bonds were acquired; how much was paid; the circumstances under which each individual purchase was made. Were any of the bonds purchased prior to the filing of these proceedings in anticipation of forestalling bondholders who might object to a further extension of the bond issue? Approximately $15,800.00 in bonds were retired from 1936 to 1942. Were any of these bonds held by the bank? Has the bank been engaged generally in the purchase and sale of these securities? Has it profited by these transactions?

The bank, the original underwriter of the issue, formed a bondholders' protective committee shortly before the default occurred, consisting of three of its own employees. Asked how the committee was formed, Haynie, an employee of the bank, said: "It was created by the three of us getting together in the Bank" (R. 21). Precisely the same procedure was followed in the 77B proceeding (R. 22). The committee then commenced to solicit bonds for deposit. Neither the committee nor the bank disclosed to bondholders that the bank had received compensation during the past six years and had the benefit of the deposit of funds. Nor was it disclosed that if a further extension of the bond issue was granted the bank expected to receive further compensation (R. 21). Neither was it disclosed that if default occurred in the bond issue the bank was entitled under the terms of the trust indenture to foreclosure fees and that its attorneys would also be entitled to fees. The bondholders' committee was dissolved when it appeared that the activities of the committee had violated the Securities Act of 1933 in failing to register the certificates of deposit. To obviate the difficulty, however, the individual members of the committee constituted themselves as "attorneys in fact" for the bondholders (R. 23). Counsel for the committee also represents the "attorneys in fact" and is the same counsel who filed the foreclosure

for the indenture trustee on the same date this instant proceeding was filed (R. 39). He drafted the plan (R. 39). The indenture trustee and the "attorneys in fact" have supported this plan (R. 23). They have actively opposed the application of this objector for an appraisal. They opposed the objections filed by this petitioner to the plan of reorganization; they opposed the application of this petitioner for an order requesting the Securities and Exchange Commission to participate in the proceeding; they failed and refused to file a list of bondholders until ordered by this Court to do so; (R. 83) they failed to call to the attention of the bondholders and the Court that the bonds and the trust indenture provided for the payment of 7% interest after maturity (May 10, 1942).

Why does the bank as indenture trustee advocate a further extension of the bonded indebtedness instead of a sale of the property at a time when the market for property of this character is most favorable? We asked Mr. Haynie, the bank's witness, to estimate the number of properties upon which the bank acts as indenture trustee (R. 35). The Referee sustained an objection to the question saying "It is indenture trustee on a lot of properties. I know that and every referee and every judge knows that. I don't want you to go into details." (R. 35). We believe we were entitled to ascertain the bank's personal interest in the plan and to show the bank has a vital and economic interest in continuing this and other trusteeships. While the return to the bank on a single building may be inconsequential, that return multiplied several hundred times from similar trusts produces substantial income, and, in addition, the bank's deposits swell and larger sums are available for loans and investment.

In *American United Mutual Life Insurance Company v. City of Avan Park*, 311 U. S. 138, this Court proclaimed some fundamental principles relating to the duties and

responsibilities of trustees which are applicable to this case, pp. 144-145:

> " * * Here the fiscal agent was acting in a dual capacity. While it was representing the City, it likewise purported to represent the interest of the bondholders. The very minimum requirement for fair dealing was the elementary obligation *of full disclosure of all its interests. And the burden was on it to show at least that such disclosure was made.* * * * " (Emphasis ours)
>
> " * * Where such investigation discloses the existence of unfair dealing, a breach of fiduciary obligation, profiting from a trust, special benefits for the reorganizers, or the need for protection of investors from the encroachments of another, the court has ample power to adjust the remedy to meet the need. * * * *The requirement of full, unequivocal disclosure; the limitation of the vote to the amount paid for the securities; the separate classification of claimants; the complete subordination of some claims, indicate the range and type of power which a court of bankruptcy may exercise in these proceedings.* That power is ample for the exigencies of varying situations." (Emphasis ours)

And this Court further said in *Woods* v. *City National Bank & Trust Company of Chicago*, 312 U. S. 262, 266-267:

> " * * * *The indenture trustee represents all the bondholders;* the committee those who have given it authorizations—in this case about 50 per cent. Where the interests of majorities and minorities do not coincide, the interests of the indenture trustee and the committee will tend to be antognonistic. Beyond that is the fact that an indenture trustee closely affiliated with a committee shares the committee's conflicts of interests." (Emphasis ours)

We asked the District Court to conduct a full inquiry into the conduct and activities of the Chicago City Bank

and Trust Company as indenture trustee and to remove it (R. 152, 172). The District Court declined. The Court of Appeals ruled that the record does not disclose conflicting interests to warrant its removal.

Under the circumstances the Referee should have conducted a full inquiry into the activities of the Bank as indenture trustee, after which the Court should have determined what, if any, action it should take. As this Court said in the *City of Avon* case, *supra,* "The court has ample power to adjust the remedy to meet the need".

VI.

Chapter X, Section 216 (10) of the Bankruptcy Act authorizes the approval of a plan providing for a sale of the debtor's property at an upset price. Fidelity Assurance Association v. Sims, 318 U. S. 608, does not prohibit the approval or confirmation of such a plan.

We asserted before the Referee and the District Court that a favorable real estate market presently exists for the property involved, and that the plan should be modified to require a sale or to permit bondholders who desired payment to receive such payment. Commenting on this objection, the Referee stated that "Chapter X contemplates reorganization rather than liquidation" (R. 104).

Chapter X, Sec. 216 (10) provides that a plan of reorganization under this Chapter may include " * * * the sale of all or any part of the property, either subject to or free from any lien, at not less than a fair upset price, and the distribution of all or any assets, or the proceeds derived from the sale thereof, among those having an interest therein; * * * "

Fidelity Assurance Association v. *Sims,* 318 U. S. 608, has created doubt as to whether a plan of reorganiza-

tion may provide for the sale of the Debtor's property at an upset price. The Referee believed that the *Sims* case prohibited a sale of the Debtor's property. It is submitted the *Sims* case is not in contravention of the Statute. The *Sims* case involved the question whether the original petition for reorganiaztion was filed in good faith because at the outset of the proceedings it appeared unreasonable to expect that a plan of reorganization could be confirmed. It appeared that the petitioner's only hope was conversion of its assets into cash and a distribution of cash to the security holders. This, this Court said, was not good faith. The *Sims* case does not prohibit a sale under a plan of reorganization, and in view of the present favorable real estate market the lower Court erred in repudiating the suggestions for a plan involving a sale on the ground that it was liquidation rather than reorganization.

CONCLUSION.

We submit that the factors which warrant relief in this case are:

1. The opinion of the Circuit Court of Appeals for the Seventh Circuit holds that notwithstanding an interest rate of 7% is fixed in the bonds and the trust indenture as payable after maturity, a plan of reorganization may extend the maturity date of the debt, fix an interest rate lower than the contract rate and at the same time allow stockholder participation. The opinion departs from the "priority rule" as announced by this Court in the *Boyd* case and in the *Los Angeles Lumber Products* case, and calls for the exercise by this Court of its power of supervision. A decision on this subject is of vital importance in reorganization law. Literally thousands of trust indentures in Illinois provide for 7% interest rate after maturity. The rate is valid and legal under Illinois law. Plans have been con-

firmed in the Northern District of Illinois which uphold this after maturity interest rate. The ruling of the court below results in a clear confiscation of the bondholders' property right to the benefit of stockholders.

2. The opinion of the Circuit Court of Appeals for the Seventh Circuit departs from the accepted and usual course of procedure under Chapter X of the Bankruptcy Act and under the decisions of this Court in holding that a specific objection must be made by a creditor to a plan of reorganization as violating the *priority rule* or the objection is waived as to the entire class of creditors. It calls for the exercise by this court of its power of supervision.

3. The opinion of the Circuit Court of Appeals for the Seventh Circuit departs from the principle announced by this Court in *Group of Investors* v. *Milwaukee Railroad*, 318 U. S. 523, and *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, viz., that interest at the contract rate must be treated the same as principal and given the same priority as principal. The opinion calls for the exercise by this Court of its power of supervision.

4. The opinion of the Circuit Court of Appeals for the Seventh Circuit in upholding the plan as feasible ignores the poor past earnings record of the building, contrary to the holdings of this Court in *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, and relies entirely on war earnings contrary to *Group of Investors* v. *Milwaukee Railroad*, 318 U. S. 523. A decision by this Court on the question of feasibility of a plan of reorganization involving a real estate enterprise is of prime importance in federal reorganization law.

5. The opinion of the Circuit Court of Appeals for the Seventh Circuit ignores the requirement under Section 174 of Chapter X that there be available to the court and interested parties competent valuation data from disin-

terested sources relating to the debtor's property and earning power to determine whether or not a plan should be approved for submission to creditors and stockholders. The failure to observe this necessary procedural requirement of Chapter X operates to the disadvantage of the interested parties and the court. Without competent valuation data the Court cannot exercise its own "informed, independent judgment" and the interested parties cannot intelligently vote on the plan.

6. Chapter X, Section 216 (10) of the Bankruptcy Act expressly authorizes a plan for a sale at an upset price. Does *Fidelity Assurance Association* v. *Sims*, 318 U. S. 608, prohibit such a plan? The question is in confusion and needs clarification.

Wherefore, it is earnestly urged that certiorari be granted by this Court, requiring the Circuit Court of Appeals for the Seventh Circuit to certify the record in this case to this Court for review and determination.

Respectfully submitted,

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